

RICHARD RUSSELL'S DOW THEORY LETTERS, INC.

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LETTER 820

Oct. 9, DJIA 873.00; PTI 1417; A-D Ratio -23.01

Oct. 16, DJIA 851.69; PTI 1403; A-D Ratio -23.40

THE PICTURE: *Business Week's* estimate of the cost of this primary bear market (including losses in bonds, real estate, commodities and stocks) is \$2 trillion dollars so far! When you consider that the huge US national debt is \$1 trillion, this gives you some idea of the scope and enormity of the markets and the size of the losses due to the bear. Furthermore, the slowdown in the economy is no longer limited to housing and autos. It is beginning to creep into many other industries from semi-conductors to aluminum to furniture, and this has not gone unnoticed by the Administration.

A slump would play havoc with the Reagan economic and fiscal projection. Remember, Reaganomics planned on a rise of 5% or more in the GNP and a decline in interest rates to the 7-9% level. With unemployment rising, corporate profits tailing off and interest still high, the 1982 deficit threatens to become a barn-burner (some are estimating up to \$100 billion). The bear has a lot of tricks up his sleeve, but his most worrisome trick could well be a whopping Federal deficit and monetary crusher in 1982.

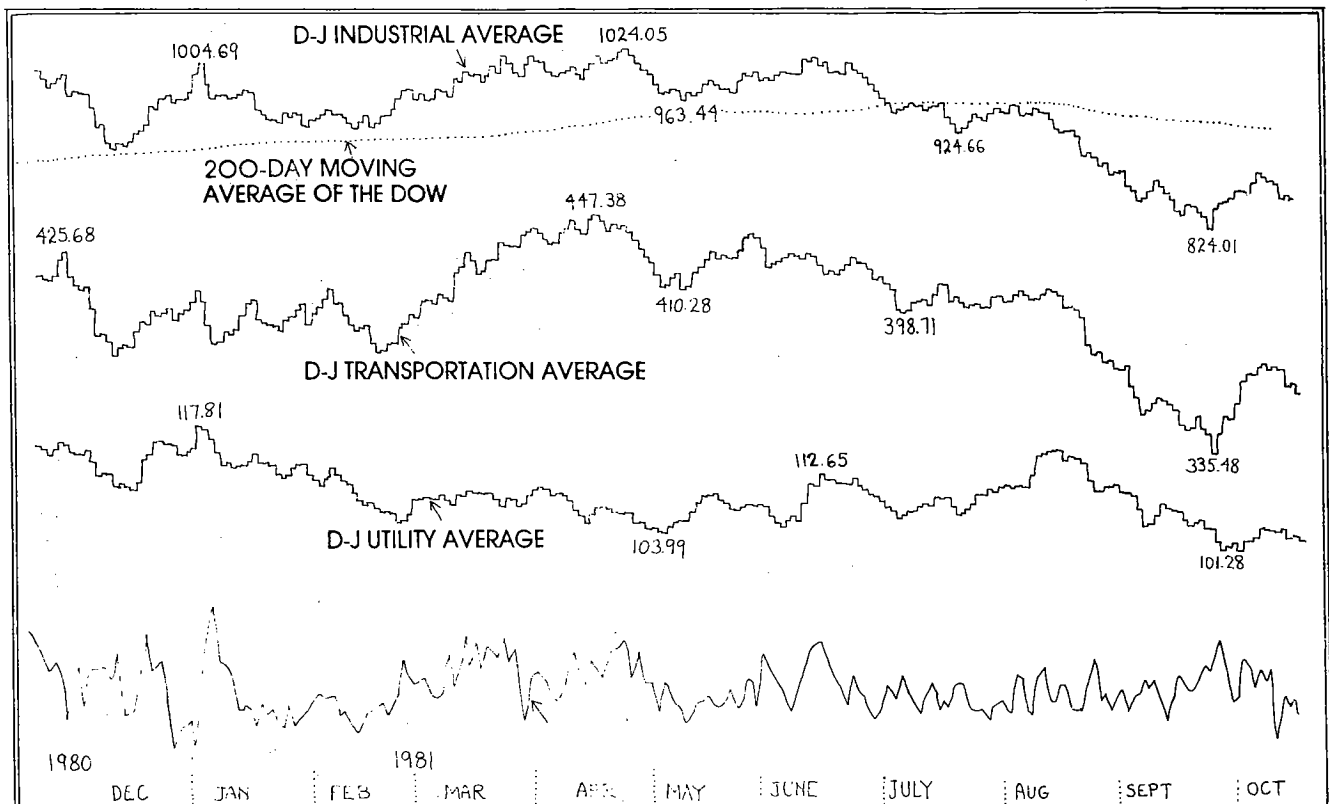
As far as the stock market is concerned, I talked in recent Letters about the three phases of a bear market. These are psychological (sentiment) phases, and they should not be confused with price movements. The first phase of a bear market is the one wherein the market sells minus the froth and excitement of the preceding bull market top. The drop from Dow 1024.04 (April 27) to 824.01 (September 25) completed the first phase of the bear market.

FRONT PAGE COMMENT: The 1982 (and beyond) Federal budget deficits loom larger and larger. Defense spending could be cut, but President Reagan rules that out. Social spending could be cut, but Congress stubbornly refuses to make cuts there. Taxes could be raised, but both sides back off on that one. The Fed could open the floodgates of inflation, but the markets won't accept that.

So what happens. Best bet is a "modifying" of the new tax cuts, putting them off six months or so, or even cutting the cuts, say to 5-5-5 instead of 5-10-10. Then there is always the possibility (a good one) that NOTHING will be done, and in that case the Democrats will just let the Administration (and the nation) strangle in deficits.

Not to worry, it's all happening on a state level as well. For instance, California's tax receipts are running \$300 million behind for the first three months while projected state spending is running about \$360 million above projected amounts. Result: a near — \$1 billion state deficit unless massive budget cuts are made or new taxes are "found." So the debt monster is growing, growing, and it promises to raise hell in 1982.

Very often (but not always) the psychological phases are separated by actual corrections in the price movement. In my opinion, the rally from the September 25 lows is just such a correction. When the primary bear forces assert themselves again we will be in the second phase of the bear market. The second phase is the one in which the market goes down in reflection of obvious deterioration in business and the economy.



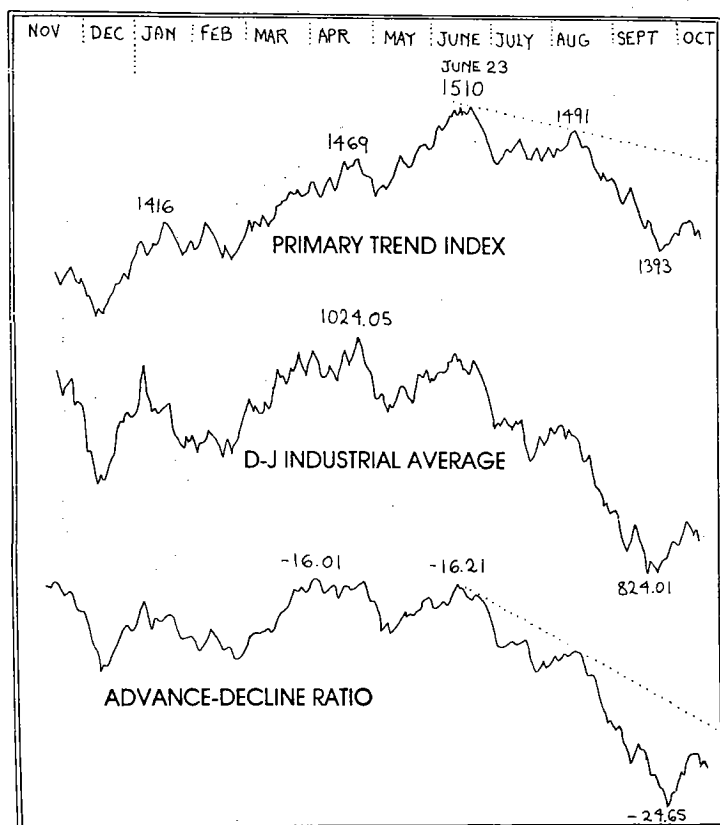
Trying to out-think and out-trade a bear market rally is one of the most difficult and frustrating exercises imaginable — and I don't recommend it. The bear will (on every bear market rally) try to entice you, excite you, intrigue you. I've written before that "the bear loves company." The bear enjoys taking as many investors as possible with him when the market goes down. Thus, the bear is hoping to attract a new group of stockholders into the market prior to the next decline. If enough people believe that "we've seen the bottom," they are going to buy stocks and sit with those stocks. This is exactly what the bear is praying for.

How will we know when the second phase of the bear market is on? Simple, the confirmation of the second phase will come if and when the Averages break below their September 25 lows, Industrials below 824.01 and Transports below 335.48.

The Utility Average, although it plays no part in Dow Theory, is often a bellwether. Any break below the year's low of 101.28 for Utilities should be accepted as a harbinger of trouble.

PRICE MOVEMENT: From the September 25 lows of 824.01 (Industrials) and 335.48 (Transports) respectively, the D-J Averages pushed up in what to my mind is nothing more than a bear market rally. Studying the page 1 chart of the Averages, you can see that correction is only in its third week. Furthermore, the extent of the correction is not particularly impressive so far. Industrials have retraced about 28% of their 200 point loss since last April's high. The Transports have corrected about 35% of their losses. The Utility Average has shown the least inclination to rally. Since the September 28 low of 101.28, Utilities advanced less than 4 points.

Another point to consider is that bear market corrections usually develop two or more upward thrusts. So far, we have only seen one (ending at Dow 878.14 on Oct. 8). Therefore, it would not surprise me to see some more upward action ending with a second or even a third peak — before the bear takes hold again.



Turning to the page 2 chart of the Primary Trend Index, the same story is being told here. At its October 12 high of 1419, the PTI had rallied 26 points above its September 25 low of 1393. That unimpressive rally corrected 23% of the 117 point loss in the PTI since its June 23 high of 1510. And as you can see on the chart, the PTI remains well below its declining trendline.

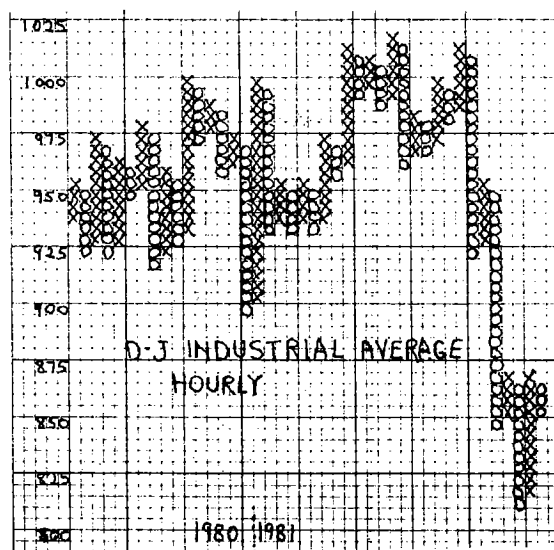
By the same token, the A-D ratio for the NYSE pushed approximately 2 points above its September 25 low. On both measurements (the PTI and the A-D ratio) I would normally expect more upward correction than the meager amounts we have seen so far.

As far as sentiment is concerned, I note that only 2-3 weeks after the September 25 low many market observers are already talking about a "major bottom" and even "a new bull market." Major bear market bottoms don't turn the boys bullish after a few weeks of upside action. My guess is that the bear has been playing games with the optimists. But this bear's got a lot of tricks up his sleeve, and he's got time — plenty of time.

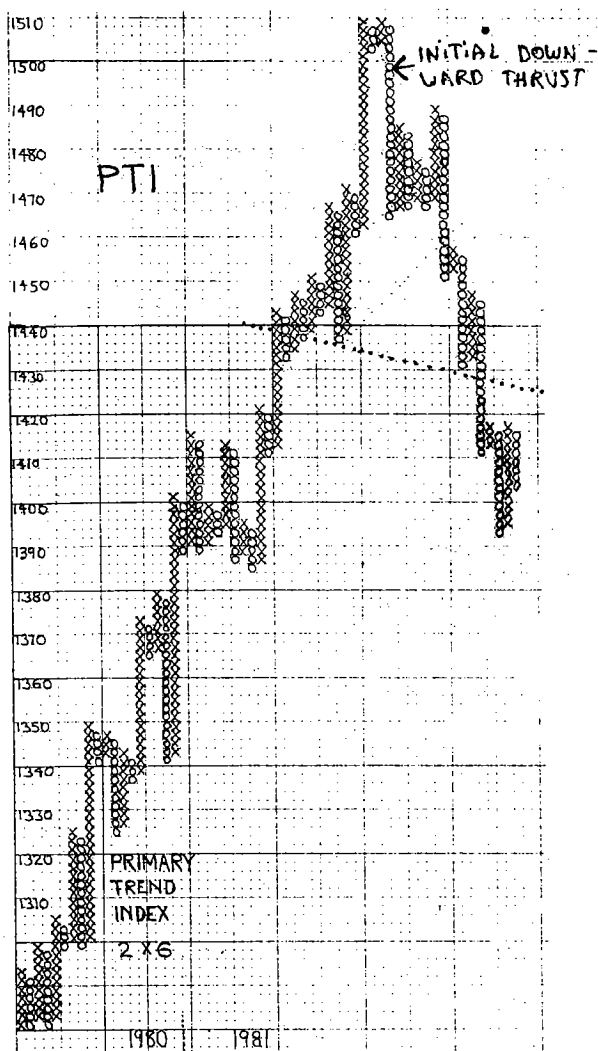
POINT & FIGURE: It's been a long time since I did any chart-teaching in these reports, but I've had a great many requests for information on the point & figure count or projection, and how to arrive at that projection.

First I should say that the so-called count on point & figure is not guaranteed, and it's not certain. But the count is an interesting part of point & figure analysis, and I do watch the count, particularly when I receive a point & figure (buy or sell) following a recognizable chart formation.

There are a number of methods of taking the count, but the one I usually use is the so-called vertical count. This is based on the principle that the *initial thrust* out of a formation contains the secret of how far the entire move may carry (or at least the minimum distance the move will carry). The theory is that the greater the initial thrust, the *farther* the move will ultimately carry. In the point & figure method, we can actually make projections based on the initial thrust, and in so doing estimate how far the move will ultimately carry.



As an example, let's take this P&F chart of the current Dow. This is a 5x15 point chart which means that each box on the chart equals 5 points and only reversals (rallies or declines) of 15 points or more are shown. Note that following the peak of 1510 there was a decline to the 925 box. That was a decline of 18 boxes. Since we are dealing with a three box (15 point) reversal chart,



we multiply the 90 points by 3 and we get 270 points. Taking the high of 1510 and subtracting 270 points we get a count (a projection) of 745 for the Dow. Thus, the minimum projection on the downside is that (in due time) the Dow will touch 745.

A second interesting and timely chart is this 2x6 point & figure chart (page 3) of the PTI. Each box here equals 2 points and only reversals of 6 points or more are depicted. Note that the PTI topped out at a value of 1510. The initial downward thrust from the 1510 high was 22 boxes. Since each box equals 2 points that's a total of 44. Since this is a three box (6 point) reversal chart, we multiply the 44 by 3 which is 132 points. Subtracting 132 from the high of 1510 gives an ultimate minimum projection of 1378.

In the last Letter I stated that the PTI formation, as seen on the P&F chart, indicated a bearish head & shoulders top pattern. I said further that the PTI was working on the right shoulder of this pattern. Last week appeared to see the completion of the right shoulder formation (although I did not think it would complete this soon). If so, the next move should be a shattering of the support at around 1392 — and a new slide in the PTI (and, with it of course, the general stock market).

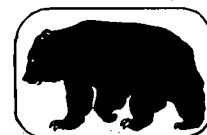
Conclusion: The P&F projection is for a minimum decline to 745 for the Dow, 1378 for the PTI. At the September low the Dow got down to 824 while the PTI dropped to 1394. Both lows were well above the point & figure projections. From the standpoint of P&F studies, the decline (in due time) should carry down to, or past, the P&F projections.

Question: What are the odds that the P&F projections will be hit?

Answer: If the thrust or breakout is in the direction of the primary trend, the odds that the projection will be hit are good. In fact, the odds are high that the projection will eventually be surpassed.

MONEY: There has been some easing in short-term interest rates with the 91-day bills down to yields of just over 13%. But the long-term market has not confirmed, and bond prices are still generally in their historic low area. My own guess is that this is just a "breather" in the long-term squeeze on money instruments. With the Government coming in for upward of \$60 billion in new money between now and March, 1982, and with a tax receipts short-fall almost sure to develop now due to the recession, I expect the pressure on interest rates to remain. Nothing has changed except that military expenditures are going higher than anyone now imagines. If there were any doubts about a US military spending explosion, the Sadat assassination should disperse those doubts.

INVESTMENT POSITION: I've said this dozens of times before, but I want to repeat it now. One of the prime requirements for successful investing is **PATIENCE**. People will spend whole vacations with boring strangers, they will listen for hours to droning lectures or sermons, they will sit for years with bad marriages, but they hate to wait for the market to tell its story.



You can't hurry the market any more than you can hurry the tides of the ocean. The market will tell its story in its own good time, and all your in-and-out trading, your switching, your board-room fidgeting and your urgent conversations with your broker won't change the market's schedule a whit. That's why I say, "Sit tight, let the situation evolve, let the trends express themselves. And above all — don't allow your money to be frittered away by impetuous trading and a series of rash, wrong moves."

The last signal given by the Dow Theory was a primary bear signal. That means that the odds favor lower markets. Nothing is guaranteed in this business, but playing against the odds is a sure way to batter your bank account.

There are still plenty of bulls around, and they're urging accumulation of stocks now. The bull case, to my mind, is a tenuous one at this point. The best I see (in deference to the bulls) is perhaps a holding action for a while rather than an immediate new bear market plunge. To my mind, the most intelligent stand is the one dictated by correct market procedure and patience. This stand is to sit tight, hold on to your Treasury bills and collect the prevailing very attractive high rates of interest.

RUSSELL CRYSTAL BALL: **Question:** Russell, you always piously assert that you don't own a crystal ball. But you must have some idea or concept of what this bear market is all about and what it portends. How about putting those ideas down in print?

Answer: Well, I do have certain theories about what's happening. First, let's go back over some history. I believe that a major economic expansion began in 1932, began from the depths of the Great Depression. For 10 years that change was all but invisible, and as far as the average person was concerned, a depression was still in force. In reality, the 1932-42 period was one of debt liquidation, base building, hard work. Then came World War II

and the nation lurched forward into full production which was, of course, mostly armament production. Following this period, the Post-War building era started. Everybody needed a house, a car, a washing machine, and a period of fantastic prosperity was ushered in. By my reckoning, this period lasted on a healthy basis until about 1966.

From 1966 onward the nation moved increasingly into debt, inflation, speculation and a variety of unhealthy economic practices. The emphasis in the US was more and more towards materialism, visible wealth, mass entertainment and service rather than production. As far as production was concerned, West Germany and increasingly Japan and Asia moved into this area.

For the 7 years between 1966 and 1973 the deterioration in America's economic health and competitive ability was masked — invisible to the average person. Then came the crushing stock market collapse of 1973-74. The 1973-74 period, I believe, marked the beginning of visible deterioration for the US economy. The early but still-visible period of deterioration lasted from 1974 to the present — to around 1980-81.

Question: All right, you've brought us to the present. What happens now?

Answer: From here on and perhaps for a decade or longer I think we are going to see the painful part of this long-term bear market, a bear market which by my thinking began in 1966. I say the painful part, because from here on the nation's debt is going to be increasingly painful to carry.

Up to the present, the US (via monetary manipulation) has been able to put off the painful part of the debt situation. But the compounding process is now beginning to accelerate at such a pace that the pain can no longer be masked. From here on I see lowered economic expectations, pressure on everyone from the government to the states to the corporations and individuals, budgets that are out-of-whack, frantic attempts to rearrange budgets, tax gimmicks, money short-falls — all the problems connected with a nation that has lived over its head for almost half a century.

Question: You say, Russell, that we are just now going into the age of debt-problems?

Answer: No, the debts have been a problem for a long time. I'm saying that we are going into the period wherein the debt problems will no longer be able to be hidden, put off or manipulated. This will mean lowered standards of living, lowered services from Government, lowered expectations. You might say that ours is the first generation in US history that cannot look forward to a better standard of living for its children. You can almost feel, see and hear the difference. The Rock and Roll music has died down, the college protests have been muted, the madness of youth has changed to the seriousness of job hunting. Today the American people are gripped by a strange feeling of anxiety, unexplained fear, thwarted expectation.

Question: Isn't there any way out of this mess?

Answer: We've been following the path of avoidance ever since 1966. Avoidance has been our "way out." But what I'm saying is that the period of successful avoidance is about over. The age of reality is upon us. By late-1982 the markets should be making this clear to us. I feel that so far here in 1981 the public and Wall

Street don't really believe this is a bear market. They believe it is just another downward jab in an ever-rising stock market. But I don't see it that way. I view the present situation as the beginning of a long, tedious, tragic struggle with a debt, inflated budgets, negative compounding interest rates and shattered financial dreams.

The bitter fact is that the US has built up a grand total of \$4.8 trillion in debt, and I list the debt below (courtesy of *Weiss Research*, Box 2923, W. Palm Beach, FL 33402). Weiss estimates the losses so far on the debt to be \$1.2 trillion.

Estimated Paper Losses On U.S. Debts		

(bill. of \$)	Amount	Est.
Debt Instrument	Outstanding	Paper
	6/30/81	Losses
		9/11/81

U.S. Gov't Sec's	1,097.9	81
State & Local	347.0	160
Corp. & For. Bonds	503.2	184
Mortgages	1,509.2	670
Consumer Credit	393.3	20
Bank Loans	479.5	62
Open Market Paper	212.0	--
Other Loans	345.9	50

Total:		4,888.0 1,227

Question: So what, Russell. We've had debt for a long time. Why is the debt any different today?

Answer: Because the payments on the debt and the losses on the debt are now beginning to eat this nation up alive. I said years ago and I'll repeat, with the level of debt this high, the US must "inflate or die." The only way we've handled (serviced) our debt over recent years is through the process of inflation — or paying off borrowed hard dollars with soft, inflated dollars. Now that process has hit a brick wall. The cost of new dollars is high, very high (the cost is gauged by interest rates). We have in Washington an Administration that has promised to bring down or even end the inflation. Thus, as things stand, the US is moving into a period of declining inflation, and the next step will be deflation. There is no standing still when you are carrying \$4.8 trillion in debt. You either inflate (to carry that debt) or deflate as the debt acts to slam on the brakes. I see the latter occurring.

Question: Russell, won't the Government go back to inflation if the economy starts sliding?

Answer: They might try, but our capital markets won't stand for it. The long-term bond market is now sick, very sick. The mortgage market is moribund. If the Administration again resorts to inflation as a way out of this mess, we'll shortly see a collapse in debt (money instruments) that will make the cave-in up to now look like a garden party. No, I don't think inflation as a remedy is going to work any more. That's why I say we're moving into the *age of reality*. That age could last 5, 10 years or longer.

Question: That's a horribly depressing thought, Russell. Do you see the coming period as one long bear market?

Answer: Perhaps, but more likely a series of bear markets separated by periods of rally, hope, new gimmicks (such as today's tax cuts). The overall picture will be one of debt problems and debt liquidation. This will be very hard on many Americans, particularly those who have been enjoying a "free ride" via the Government or the state or some agency. I foresee saving coming

back again. I see money and capital having meaning and value again. And I see a tremendous revulsion building up against debt and deficits — particularly when the people realize how debt and deficits have undermined the strength and power of America. But all this will take time.

Question: What do we as investors do in the coming period?

Answer: We watch the markets, we try to unfathom the trend of events, we use our brains, we tend to our spiritual, psychological and physical needs, and we simply do the best we can.

I'll confess something. I firmly believe that the pursuit of truth will stand a person in good stead. All life is an exercise in seeking truth, and then doing the right thing based on what you have discovered about the truth. The reason I don't like debt is that debt tends to be a lie. Ultimately, all debt is paid off or reneged on (bankruptcy). The US debt will never be repaid, and therefore it is a lie. Our job now is to live by the truth. If we do, we will survive, be happy and perhaps even prosper. But if we continue to ignore the truth, our only reward will be the pain that we have so long avoided.

Question: Russell, are you seriously saying that economics is some kind of morality play?

Answer: Call it what you want, economics is subject to the truth as is everything else. Run a business or a government on a deceitful basis and it will topple. In government as in business and in life, two plus two equals four.

NOTES & QUOTES: On the weekend of October 3 Treasury Secretary Regan urged the Federal Reserve Board to make the nation's money supply grow faster. The Treasury Secretary is supposed to be the defender of the currency. Thus, we have the spectacle of the dollar's defender urging the Fed to increase the rate of inflation in the currency. And this is the Administration that is talking about bringing back gold? I say, "forget it!"

* *

The Oct. 5 *Wall Street Journal* (Editorial page) carries a piece which states the deficits don't matter. In the old days they used to say that deficits don't matter "because we owe it to ourselves." The new buzz phrase is, "Deficits don't matter because they're such a small percentage of our GNP." But I have news for the *WSJ*. Deficits DO matter, if for no other reason than that they scare hell out of the bond market. They scare the bond market because deficits have to be financed (via bond, note or bill sales) or via monetization. Either way, the bond market is a loser. So go tell our money markets that deficits don't matter!

* *

Oil earnings for OPEC could drop up to \$4 billion this year, and this could put a crunch on some of the OPEC members' economies. Nigeria, Venezuela and Libya are prime candidates for trouble.

* *

On October 5 Alcoa and Reynolds Metals raised prices 7 to 9% on alloy aluminum sheets and plate. Business has been very slow at the aluminum companies, so prices have probably been raised on the theory that if you can't sell it at current prices, you might as well not sell it at higher prices.

* *

The November *Science Digest* magazine has a fascinating and important 12-page article on what is becoming a Western obsession — Japan's phenomenal success in business. In the past 30 years Japan's productivity has increased 11 fold, a yearly growth

of 8.5% and twice the US rate. Japan (with half the US population) is now graduating more engineers than the US. The next step in Japan's master plan: instead of improving on the best foreign technology, Japan intends to create its own new technology.

Following is a section of the article, a section written by Mitsudo Shimomura:

Japan's high-tech, high-yield, high-quality out-

Every morning, 87,000 Matsushita employees throughout Japan sing the company song and recite the company creed and code of values.

Employees' Creed: "Progress and development can be realized only through the combined efforts and cooperation of each member of our Company. Each of us, therefore, shall keep this idea constantly in mind as we devote ourselves to the continuous improvement of our Company."

The Seven "Spiritual" Values: National service through industry; fairness; harmony and cooperation; struggle for betterment; courtesy and humility; adjustment and assimilation; and gratitude.

put depends on a distinctive management style. For some time, I have felt that the difference between Eastern and Western management is rooted in attitudes toward work. In general, people of the Western countries see work as a restriction on personal liberty; one trades freedom for a salary. Managers don't trust workers to further the interests of the company, and workers feel used by their firms.

In Japan, however, work is not considered to be an infringement on human freedom. The Japanese believe that to work is to live and that at work one establishes one's identity. Neither blue- nor white-collar workers consider their interests to be opposed to those of the company; a worker's salary and bonuses reflect the company's success.

There is an idiom in Japan: "to eat from the same pot." Anyone associated with a business enterprise "eats from the same pot" whether he be a welder, a switchboard operator, a chemist or an accountant. If the pot were to disappear, everyone would go hungry. But when the pot is full, the fruits of labor are shared by all.

* *

At last, a happy rumor. The rumor is that Russia is looking for a face-saving way of getting out of Afghanistan. The problem: The Afghan war is costing the Russians hundreds of millions. Russians have failed to capture the countryside. Morale among Russians in Afghanistan has hit bottom due to fierce resistance of Afghans, plus the Afghan habit of torturing and killing all captured Russians.

Best chance of Russian pullout would be a military withdrawal with an international agreement of noninterference in Afghan internal affairs.

* *

We can expect new taxes coming out as President Reagan attempts to hold down deficits. Possible areas — higher cigarette, alcohol, gasoline, telephone taxes. Possibly a cut in the 5-10-10 income tax to 5-5-5. Or a windfall profits tax on natural gas in view of its coming deregulation. Any way you look at it, the taxes come out of the pockets of Americans. What the Administration giveth, the Administration taketh away. Reagan is absolutely firm on the military buildup, and with the coming of the buildup there is going to be a mad scramble to finance that

buildup in a way that will run US deficits through the roof and into the wild blue yonder.

* * *

I recently spoke to a Navy pilot who had just returned from the Mideast. At one point in our conversation he said, "We're not scared of the Russians, we know where they are. We're scared of some guy like Qaddafi pulling the switch." In the current issue of *Playboy* there is a fascinating interview with Oriana Fallaci, the famous Italian journalist. She talks about her interview with Qaddafi of Libya, and I thought what she said was important enough to include here (following are a few quotes):

PLAYBOY: Before that, there was your interview with Qaddafi, which you've already mentioned.

FALLACI: That one was truly scary. Qaddafi is clinically sick, mentally ill, a certifiable idiot. You cannot deal with him. He made me wait three and a half hours outside his offices in Libya. He sits in the center office of his palace, surrounded by four or five circles of protective barricades, like German check points. It's like entering a spiral. There are dozens of people standing around with machine guns.

PLAYBOY: When did you become convinced he was insane?

FALLACI: You should listen to my tape. For ten minutes, ten full minutes, he is yelling, like a broken record, "I am the gospel, I am the gospel, I am the gospel." It's terrible, because he never stops, never stops. His face—his face is so out of this world while this is going on that I nudge my photographer to take the picture then. But the photographer was so scared he couldn't move his hands, and the interpreter was trembling, too.

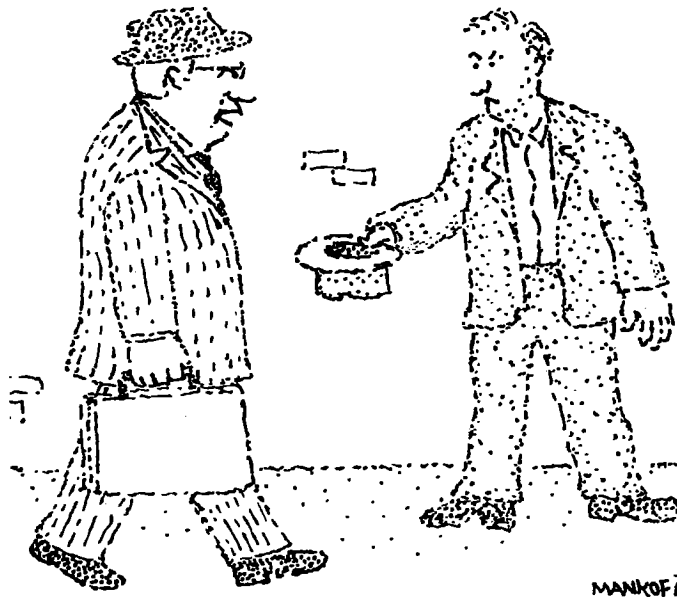
and then the interview went on and I knew I would not be arrested. But he is insane. He is obsessed with the color green, you know.

PLAYBOY: Green?

FALLACI: Everything around him is green. His handkerchief, everything is green. As we were sitting there, I picked up something—I forget what it was—that happened to be green, and something must have happened in his consciousness. He looked like he was going to strangle me. So I said, "Would you like it? Do you want this?" I gave it to him, and he took it. Immediately. He wanted it so much. He should be under the care of a psychiatric doctor. Dangerous, dangerous, dangerous.

NEXT MAILING: Nov. 4

Here's a cartoon that really struck my funny bone. The Welfare Dept. is going to like this one (Courtesy the *New Yorker*).



"For God's sake, man, give the President's program a chance!"

GOLD: Here's a beautiful gold chart from Harry Browne's Special Reports (Box 5586, Austin, TX 78763). The chart is drawn to ratio scale, so the chart deals with percentages of movements (on this chart a rise from 100 to 200 shows as the exact same vertical distance as a rise from 250 to 500).

What this chart shows is that the rising trend which began in February, 1976 at 103.50 is still intact — but barely. When gold broke below 400 it actually did break below the 5-year trendline, but the trend was quickly re-established as gold popped above the trendline again.

My own interpretation of the gold picture at this time is that gold MUST hold above the 400 level and even more important gold must hold above the recent 392 low. Any drop below 392 will not only post a new low but will decisively crack the 5-year rising trend. If this occurs, I think the odds for deflation will rise tremendously.

In the next Letter I intend to include a special study on gold and world markets which, I am certain, will prove to be an absolute shocker to my readers.

